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## Figuring Self-Employment Tax

Self-employment tax provides funds for Social Security and Medicare benefits. The self-employment tax is calculated on Schedule SE. You are required to prepare Schedule SE if you have self-employment earnings of \$400 or more in 1996, but you will not incur the tax unless your self-employment earnings exceed \$433.13. The tax is added to your income tax liability. When preparing your estimated tax liability, you must also include an estimate of self-employment tax; see Chapter 27.

On Schedule SE, self-employment income is reduced by a deduction reflected in the decimal of .9235 listed on the form. You also deduct 50% of the self-employment tax on Line 25 of Form 1040.

For 1996, the self-employment tax of 15.3% consists of the following two rates: 12.4% for Social Security and 2.9% for Medicare. After the .9235 reduction to earnings, the 15.3% rate applies to a taxable earnings base of \$62,700 or less; the 2.9% rate applies to all taxable earnings exceeding \$62,700. For example, on taxable self-employment earnings of \$62,700, the self-employment tax would be \$9,593.10 ( $62,700 \times 15.3\%$ ). On taxable self-employment earnings (after the .9235 reduction) of \$100,000, the self-employment tax would be \$10,674.80: \$9,593.10 on the first \$62,700 of taxable self-employment earnings, *plus* \$1,081.70 on the excess \$37,300 at 2.9%.

You are required to pay self-employment tax on self-employment income even after you retire and receive Social Security benefits.

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## ¶46.1 What Is Self-Employment Income?

On Schedule SE, your self-employment income is generally your net profit from your business or profession whether you participate in its activities full or part time. Net profit is generally the amount shown on Line 31 of Schedule C (or Line 3 of Schedule C-EZ) if you are a sole proprietor. If you are a partner, net earnings subject to self-employment tax are taken from Line 15a, Schedule K-1 of Form 1065. If you are a farmer, net farm profit is shown on Line 36, Schedule F.

If you have more than one self-employed operation, your net profit from all the operations is combined. A loss in one self-employed business will reduce the income from another business. You file separate Schedules C for each operation and one Schedule SE showing the combined income (less losses, if any). Contributions to your *own* Keogh plan or SEP retirement account do not reduce the net earnings subject to self-employment tax.

**Married couples.** Where you and your spouse *each* have self-employment income, each spouse must figure separate self-employment income on a separate schedule. Each pays the tax on the separate self-employment income. Both schedules are attached to the joint return.

If you live in a community property state, business income is not treated as community property for self-employment tax purposes. The spouse who is actually carrying on the business is subject to self-employment tax on the earnings.

**Exceptions.** The following types of income or items are *not* included as self-employment income on Schedule SE:

**1. Rent from real estate is not self-employment income, unless** it is the business income of a real estate dealer or income in a business where substantial services are rendered to the occupant, as in the leasing of—

- Rooms in a hotel or in a boardinghouse.
- Apartments, but only if extra services for the occupants' convenience, such as maid service or changing linens, are provided.
- Cabins or cabanas in tourist camps where you provide maid services, linens, utensils, and swimming, boating, fishing, and other facilities, for which you do not charge separately.
- Farmland in which the landlord materially participates in the actual production of the farm or in the management of production. For purposes of "material participation," the activities of a

landlord's agent are not counted, only the landlord's actual participation.



### Real Estate Investor

The owner of one office building who holds it for investment (rather than for sale in the ordinary course of business) is not a real estate dealer, but a real estate investor. The rent income is not self-employment income. Furnishing heat, light, water, and trash and garbage collection to tenants does not produce self-employment income.

**2. Dividends and interest are not self-employment income.** However, dividends earned by a dealer in securities and interest on accounts receivable are treated as self-employment income. A dealer is one who buys stock as inventory to sell to customers.

**3. Capital gains are not self-employment income.** Similarly, not treated as self-employment income are gains from the sale of property which is not inventory or held for sale to customers in the ordinary course of business. There is an exception for dealers in commodities and options; see the chart in ¶46.6.

**Net operating loss deduction.** A loss carryover from past years does not reduce business income for self-employment tax purposes. Similarly, the personal exemption may not be used to reduce self-employment income.

**Statutory employees.** Wages of a statutory employee, such as a full-time life insurance salesperson (¶40.5), are not subject to self-employment tax, as Social Security and Medicare tax have been withheld.

**Farmers.** Cash or a payment in kind under the "Payment-in-Kind" program is considered earned income subject to self-employment tax.

**Business interruption proceeds.** The IRS and the Tax Court disagree over whether business interruption insurance proceeds must be reported as earnings subject to self-employment tax. The Tax Court held that insurance payments made to a grocer as compensation for lost earnings due to a fire were not subject to self-employment tax because the payment was not for actual services. The IRS refuses to follow the decision, holding that such payments represented income that would have been earned had business operations not been interrupted.

## ¶46.2 Partners Pay Self-Employment Tax

A general partner includes his or her share of partnership income or loss in net earnings from self-employment, including guaranteed payments. If your personal tax year is different from the partnership's tax year, you include your share of partnership income or loss for the partnership tax year ending within 1996.

A limited partner is not subject to self-employment tax on his or her share of partnership income except for guaranteed payments for services performed, which are subject to the tax.

If a general partner dies within the partnership's tax year, self-employment income includes his or her distributive share of the income earned by the partnership through the end of the month in which the death occurs. This is true even though his or her heirs or estate succeeds to the partnership rights. For this purpose, partnership income for the year is considered to be earned ratably each month.

**Partnership's retirement payments.** Retirement payments you receive from your partnership are *not* subject to self-employment tax if the following conditions are met:

1. The payments are made under a qualified written plan providing for periodic payments on retirement of partners with payments to continue until death.

2. You rendered no services in any business conducted by the partnership during the tax year of the partnership ending within or with your tax year.

3. By the end of the partnership's tax year, your share in the partnership's capital has been paid to you in full, and there is no obligation from the other partners to you other than with respect to the retirement payments under the plan.

## ¶46.3 Schedule SE

Schedule SE has an introductory "road map" designed to lead you to either the short or long version of Schedule SE. Once you pass through the road map, the preparation of either the short or long schedule is not difficult. In both versions, you multiply your net earnings by a decimal of .9235. Only 92.35% of net earnings is subject to the self-employment tax. The .9235 adjustment is the equivalent of a 7.65% reduction to net earnings, which along with the income tax deduction for 50% of self-employment tax on Line 25 of Form 1040, attempts to place self-employed individuals on the same level as employees subject to FICA taxes.

The .9235 adjustment is made on Line 4 of either the short or long Schedule SE. For example, if your net profit reported on Line 31 of Schedule C is \$100,000, the amount subject to self-employment tax after the adjustment is \$92,350; *see* the filled-in short Schedule SE worksheet below, and *see* ¶46.4 for the long Schedule SE.

Short SE Worksheet goes here. Leave at least 1 pica of white space above and 1 pica below.

## ¶46.4 How Wages Affect Self-Employment Tax

If you have both a net profit from self-employment and also wage and/or tip income subject to FICA taxes (Social Security and Medicare), the amount of such FICA earnings will affect the self-employment tax rate applied to your net profit.

If your 1996 FICA wages or tips were \$62,700 or over, your net self-employment profit is subject only to the 2.9% Medicare rate.

If your 1996 FICA wages or tips were under the \$62,700 limit for the 12.4% Social Security rate, your net self-employment earnings on Line 6 of long Schedule SE (after the .9235 adjustment) are subject to the 12.4% rate to the extent of the excess of \$62,700 over your FICA wages or tips. The 2.9% Medicare rate applies to the

entire amount of net self-employment earnings. *See* the following Example and the filled-in long Schedule SE worksheet below.

### EXAMPLE

You earn a salary of \$30,000 and have a net profit from self-employment of \$35,000. As shown on the long Schedule SE worksheet below, the 12.4% rate applies to the smaller of Line 6 and Line 9. Here, the smaller amount is the Line 6 net earnings of \$32,322.50.

12.4% × \$32,322.50	\$4,007.99
2.9% × \$32,322.50	
(net profit after .9235 adjustment)	<u>+ 937.35</u>
	4,945.34

Long Schedule SE worksheet goes here. Leave at least 1 pica of white space above and below.

## ¶46.5 Optional Method If 1996 Was a Low-Income or Loss Year

The law provides a small increased tax base for Social Security coverage if you have a low net profit or loss.

Electing the optional method may also increase earned income for dependent care and earned income credit purposes.

The increased tax base is called the optional method. One optional method is for nonfarm self-employment and another for farm income. You may not use the optional method to report an amount less than your actual net earnings from self-employment.

**Nonfarm method.** You may use the nonfarm optional method if you meet all the following tests:

- Test 1.** Your actual net earnings (profit) from nonfarm self-employment on Line 31 of Schedule C, Line 3 of Schedule C-EZ, or Line 15a of Schedule K-1 (Form 1065) are less than \$1,733 ( $.9235 \times \$1,733 = \$1,600$  maximum income subject to the optional method).
- Test 2.** Your net earnings from nonfarm employment are less than 72.189% of the total gross income you made from nonfarm self-employment.
- Test 3.** You had net earnings from self-employment of \$400 or more in at least two of the following years: 1993, 1994, and 1995.
- Test 4.** You have not previously used this method for more than four years. There is a five-year lifetime limit for use of the nonfarm optional base. The years do not have to be consecutive.

**Income of \$2,400 or less.** If your gross income from all nonfarm trades or businesses is \$2,400 or less and you meet the four tests just discussed, you may report two-thirds of the gross income from your nonfarm business as net earnings from self-employment.

### EXAMPLES

1. Brown had net earnings from self-employment of \$800 in 1994 and \$900 in 1995 and so meets Test 3 above. In 1996, she has gross nonfarm self-employment income of \$2,100 and net self-employment earnings of \$1,200. Net earnings from self-employment of \$1,200 are less than \$1,733 (Test 1 above) and also less than \$1,516 (under Test 2, 72.189% of \$2,100 gross income is \$1,516). Brown may either figure self-employment tax on actual net earnings of \$1,200 or on \$1,400 ( $\frac{2}{3}$  of \$2,100).
2. Same facts as in Example 1 but Brown has a net loss of \$700. She may elect to report \$1,400 ( $\frac{2}{3}$  of \$2,100) as net earnings under the optional method.
3. Smith had gross income of \$1,000 and net earnings of \$800. He may not use the optional method because actual net earnings of \$800 are not less than \$722 (72.189% of gross income of \$1,000).

4. Jones has gross income of \$525 and net earnings of \$175. Jones may not use the optional method because two-thirds of his gross income, or \$350, is less than the minimum income of \$400 required to be subject to the tax.

**Income over \$2,400.** If your gross income from all nonfarm businesses exceeds \$2,400, and you meet the four tests just discussed, you may report \$1,600 as your net earnings from nonfarm self-employment.

### EXAMPLES

1. White had net earnings from self-employment in 1993 of \$8,500; in 1994, \$10,500; and in 1995, \$9,500. His 1996 gross income is \$12,000 and net earnings are \$1,200. Because his net earnings of \$1,200 from self-employment are less than \$1,733 and also less than 72.189% of his gross income, he may report either \$1,600 or \$1,200 as his net earnings from self-employment.
2. Same facts as in Example 1, but assume net earnings for 1996 are \$1,800. White may not use the optional method because his actual net earnings of \$1,800 from self-employment are not less than \$1,733. He reports \$1,800 as net earnings using the regular method.
3. Assume White has a net loss of \$700 in 1996. He may use the optional method to report \$1,600 of net earnings from self-employment.

**Optional farm method.** If you have farming income (other than as a limited partner) you may use the farm optional method to figure your net earnings from farm self-employment.

The nonfarm optional method does *not* have a two-year self-employment test (Test 3) or a requirement that actual net earnings be less than 72.189% of gross income (Test 2). There is also no limitation on the number of years you may use this method (Test 4).

If your gross income from farming is \$2,400 or less, you may report two-thirds of your gross income as your net earnings from farm self-employment. If your gross income from farming exceeds \$2,400 and your actual net earnings from farm self-employment are less than \$1,733, you may report \$1,600 as your net earnings from farm self-employment. If your gross income from farming exceeds \$2,400 and your actual net earnings from farm self-employment are \$1,733 or more, you may not use the optional method.

Farm income includes income from cultivating the soil or harvesting any agricultural commodities. It also includes income from the operation of livestock, dairy, poultry, bee, fish, fruit or truck farm, or plantation, ranch, nursery, range, orchard, or oyster bed, as well as income in the form of crop shares if you materially participate in production or management of production.

## ¶46.6 Self-Employment Tax Rules for Certain Positions

<i>If you are—</i>	<i>Tax Rule—</i>
<b>Babysitter</b>	Where you perform services in your own home and determine the nature and manner of the services to be performed, you are considered to have self-employment income. However, where services are performed in the parent's home according to instructions by the parents, you are an employee of the parents and do not have self-employment earnings.
<b>Clergy</b>	<p>If you are an ordained minister, priest, or rabbi (other than a member of a religious order who has taken a vow of poverty), you are subject to self-employment tax, unless you elect not to be covered on the grounds of conscientious or religious objection to Social Security benefits. Before 1968, a minister had to elect Social Security coverage.</p> <p>An application for exemption from Social Security coverage must be filed on or before the due date of your income tax return for the second taxable year for which you have net earnings from services as a minister of \$400 or more (Form 4361).</p> <p>An exemption, once granted, is generally irrevocable. However, a law did allow revocation of the exemption for 1977 or 1978. An exemption will not be granted to a minister who elected coverage under prior law.</p> <p>A new law exempts from self-employment tax the rental value of any parsonage or parsonage allowance provided after retirement. Other retirement benefits from a church plan are also exempted. The exemptions are allowed retroactively for years beginning on, before, or after December 31, 1994, so a refund opportunity is available if self-employment tax was paid on such amounts in a prior year not closed by the statute of limitations.</p>
<b>Consultant</b>	The IRS generally takes the position that income earned by a consultant is subject to self-employment tax. The IRS has also held that a retired executive hired as a consultant by his former firm received self-employment income, even though he was subject to an agreement prohibiting him from giving advice to competing companies. According to the IRS, consulting for one firm is a business; it makes no difference that you act as a consultant only with your former company. The IRS has also imposed self-employment tax on consulting fees, although no services were performed for them. The courts have generally approved the IRS position.
<b>Dealer in commodities and options</b>	Registered options dealers and commodities dealers are subject to self-employment tax on net gains from trading in Section 1256 contracts, which include regulated futures contracts, foreign currency contracts, dealer equity options, and non-equity options. Self-employment tax also applies to net gains from trading property related to such contracts, like stock used to hedge options.
<b>Director</b>	You are taxed as a self-employed person if you are not an employee of the company. Fees for attendance at meetings are self-employment income. If the fees are not received until after the year you provide the services, you treat the fees as self-employment earnings in the year they are received.
<b>Employee of foreign government or international organization</b>	If you are a U.S. citizen and you work in the United States for a foreign government or its wholly owned instrumentality, or an international organization, you pay self-employment tax if Social Security and Medicare taxes are not withheld from your pay.
<b>Executor or guardian</b>	<p>If you are a professional fiduciary, you will always be treated as having self-employment income, regardless of the assets held by the estate. But if you serve as a nonprofessional executor or administrator for the estate of a deceased friend or relative, you will not be treated as having self-employment income unless all of the following tests are met: (1) the estate includes a business; (2) you actively participate in the operation of the business; and (3) all or part of your fee is related to your operation of the business.</p> <p>The IRS applied similar business tests to deny self-employment treatment for a guardian who was appointed by a court to care for a disabled cousin. The guardian negotiated sales of the cousin's property and invested the proceeds, but these activities were not extensive enough to be considered management of a business.</p>

## SELF-EMPLOYMENT TAX RULES FOR CERTAIN POSITIONS

<i>If you are—</i>	<i>Tax Rule—</i>
<b>Lecturer</b>	You are not taxed as a self-employed person if you give only occasional lectures. If, however, you seek lecture engagements and get them with reasonable regularity, your lecture fees are treated as self-employment income.
<b>Nonresident alien</b>	You do not pay Social Security tax on your self-employment income derived from a trade, business, or profession. This is so even though you pay income tax. Your exemption from self-employment tax is not influenced by the fact that your business in the United States is carried on by an agent, employee, or partnership of which you are a member. However, if you live in Puerto Rico, the Virgin Islands, American Samoa, or Guam, you are not considered a nonresident alien and are subject to self-employment tax.
<b>Nurse</b>	<p>If you are a registered nurse or licensed practical nurse who is hired directly by clients for private nursing services, you are considered self-employed. You are an employee if hired directly by a hospital or a private physician and work for a salary following a strict routine during fixed hours, or if you provide primarily domestic services in the home of a client.</p> <p>Where registered or licensed practical nurses are assigned nursing jobs by an agency which pays them, the IRS, in several rulings, has treated such nurses as employees of the agency.</p> <p>Nurses' aides, domestics, and other unlicensed individuals who classify themselves as practical nurses are treated by the IRS as employees, regardless of whether they work for a medical institution, a private physician, or a private household.</p>
<b>Real estate agent or door-to-door salesperson</b>	<p>Licensed real estate agents are considered self-employed if they have a contract specifying that they are not to be treated as employees and if substantially all of their pay is related to sales rather than number of hours worked.</p> <p>The same rule also applies to door-to-door salespeople with similar contracts who work on a commission basis selling products in homes or other non-retail establishments.</p>
<b>Technical service contractor</b>	<p>Consulting engineers and computer technicians who receive assignments from technical service agencies are generally treated as employees and do not pay self-employment tax. The IRS distinguishes between (1) technicians who in three-party arrangements are assigned clients by a technical services agency, and (2) those who directly enter into contracts with clients. Employee status covers only technicians in Group 1.</p> <p>Technical specialists who contract directly with clients may be classified as independent contractors by showing that they have been consistently treated as independent contractors by the client, and that other workers in similar positions have also been treated as independent contractors. Thus, they may treat their income as self-employment income.</p> <p>Firms that are treated as employers of technical specialists are responsible for withholding and payroll taxes.</p>
<b>Writer</b>	Royalties from writing books are self-employment income to a writer. Royalties on books by a professor employed by a university may also be self-employment income despite employment as a professor.

## ¶46.7 Self-Employment Tax Rule for LLCs

Under proposed IRS regulations, a manager-member of an LLC is subject to self-employment tax. A nonmanager member of an LLC is treated as a limited partner and thus not subject to self-employment tax (except on guaranteed payments for services) if: (1) the LLC could have been formed as a limited partnership in the same jurisdiction; and (2) the member could have qualified as a limited partner under applicable state law. Thus, under these tests, professionals who are barred from operating as a limited partnership by state law and who set up an LLC will be subject to self-employment tax. In addition, if under state law an LLC member would be treated as a general partner liable for partnership debts rather than as a limited

partner upon becoming actively involved in management, self-employment tax will apply to the LLC earnings.

For purposes of these proposed regulations, a “manager” subject to self-employment tax is a person who, either alone or with others, has exclusive authority to make the management decisions in the business for which the LLC was formed. If no such managers have been elected or designated, the IRS will treat every LLC member as a manager subject to self-employment tax.

The proposed regulations have been criticized by some tax professionals on the grounds that they impose self-employment tax on the basis of management rights, rather than the services actually performed by an LLC member, and also because application of the tax would vary depending on state law.

*See the Supplement for any developments concerning the IRS proposed regulations.*